Made in Italy Fund

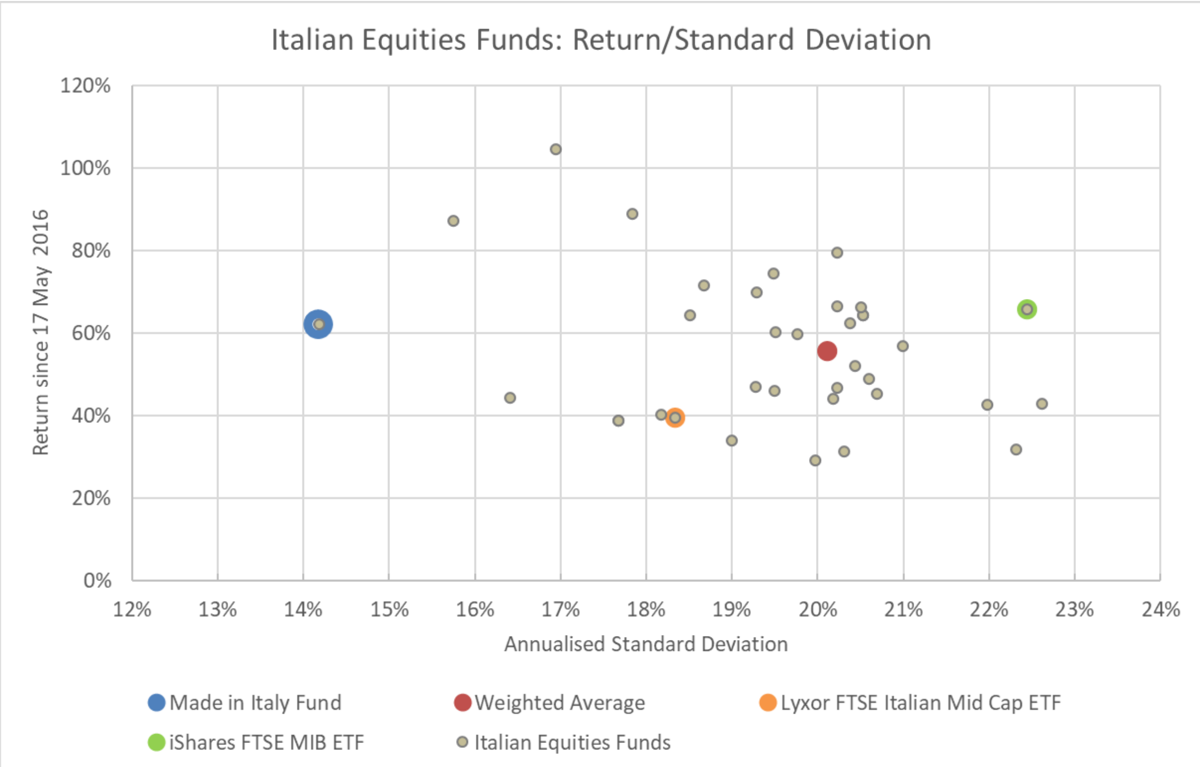
Bayes Investments

Investor letter – Fourth Quarter 2022

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of 3.9% in the fourth quarter of 2022. The return since inception (17 May 2016) is 62.1%. Returns are net of fees and all administration costs.

The MIF remained ahead of the Italian Equities fund universe, whose weighted average return since our inception is 55.6%:



Source: Factset

The MIF return is significantly higher than the 39.4% return of the most comparable ETF – the Lyxor Mid Cap Fund – but has fallen slightly below the 65.7% return of the main Italian Equities ETF – the iShares FTSE MIB.

The MIF return continues to be accompanied by lower volatility. The annualised standard deviation of its daily returns is 14.2%, compared to 20.1% for the weighted average fund, 18.3% for the Lyxor ETF and 22.4% for the iShares ETF.

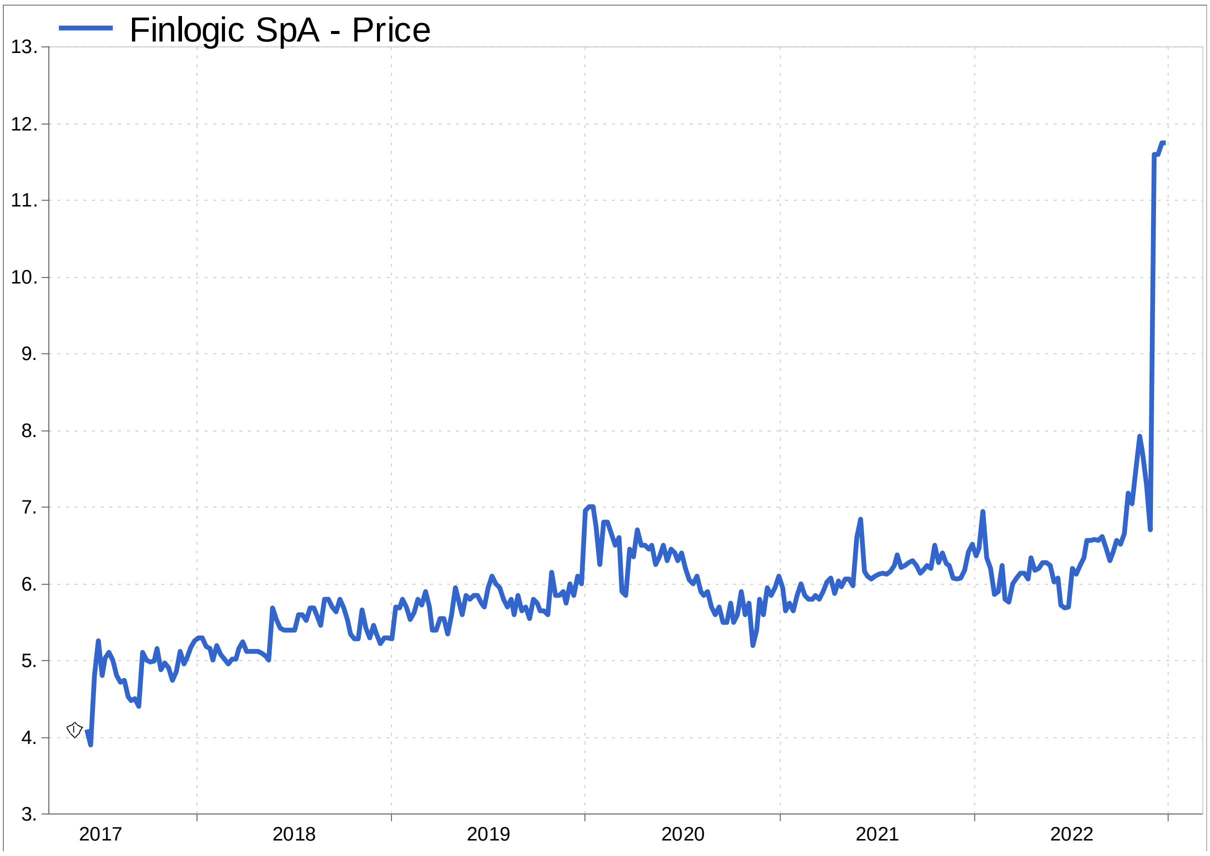
Fourth Quarter 2022

Our 3.9% return for the quarter compares with a weighted average return of 13.9% for the Italian Equities universe, 12.8% for the Lyxor ETF and 15.5% for the iShares ETF.

As predicted in our Q3 letter, global stock markets staged a significant rebound in the fourth quarter, with strong advances in October and November followed by a partial retrenchment in December. The US S&P 500 index ended the quarter up 8%, but European stocks saw stronger advances, with the Euro STOXX index up 13%, the German DAX index up 15% and the Italian MIB index up 16%. Unlike in Q3 – where they had underperformed large caps on the way down – European smaller capitalization stocks kept pace in Q4, with the Euro STOXX Small index and the German MDAX both up 12%. But Italian small caps did not follow suit and continued to underperform the MIB index, with the Italia Small Cap index up 6% and the Italia Growth index up 5%.

In keeping with its consistently lower volatility, our Fund trailed the MIB index in October and November and outperformed it in December. The net result, however, was well behind the main comparisons. This, combined with the Q3 underperformance, meant that the Fund – which had kept pace with the market in the first half of the year – fared considerably worse in the second half, ending the full year down -24.5%, versus -12.7% for the weighted average fund, -18.4% for the Lyxor ETF and -9.7% for the iShares ETF.

Many of our stocks did well in the quarter, starting with last quarter's top performer **Finlogic**, which in early December received a public takeover offer at 12 euro per share, 69% above its previous day's close, and ended the quarter up 79%, adding to its 15% increase in Q3, for a total appreciation of 84% in 2022:



As we mentioned in the Q3 letter, the stock has been in the portfolio since Q2 2017, when we first bought it at IPO for 3.6 euro per share. We subsequently increased our position, and from 2018 to early 2021 the company was our first or second top holding in the portfolio. But as the Fund grew in 2021 and we participated in new IPOs, the stock weight dropped to a lower size. As a result, the positive impact from the takeover, though sizeable, was regrettably not as large as it would have been in earlier years.

Other strong performers included **Estrima**, which ended the quarter up 30%, thus recouping most of its Q3 loss; **Cembre** – discussed in the Q3 letter – up 29%, much nearer to its 2021 year-end close; our top-5 holding **The Italian Sea Group**, which we bought at IPO in Q2 2021 at 4.9 euro per share and ended the quarter up 27% at 5.7 euro; **Pattern**, bought at IPO in Q3 2019 at 3.25 euro per share and up 27% in the quarter to 6.7 euro; **Matica Fintec**, bought at IPO in Q4 2019 at 1.7 euro per share and up 26% in the quarter to 2.6 euro; last quarter's laggard **Landi Renzo**, up 26%; **Racing Force**, up 24% on top of its 7% appreciation in Q3; **Intred** and last quarter's laggard **Websolute**, up 19%.

Many other stocks had a positive performance in the quarter, though lower than the MIB index. These include our top holding **EdiliziAcrobatica**, which nudged up another 5%. The Fund's overall performance, however, was held back by negative contributions from a number of stocks, notably **Vantea Smart** (-30%), **Tecma Solutions** (-19%) and last quarter's IPO **Solid World Group** (-14%). None of these price declines has a fundamental justification and we have no doubt that they will be recovered in due time.

During the quarter we exited one position and in early December participated in a new IPO:

Erredue. The company designs and produces gas generators, mixers and purifiers, which allow companies in various industries to produce their own technical gases on-site – clean hydrogen generated by electrolysis, nitrogen and oxygen – thus avoiding the purchase and storage of gas cylinders. The company has more recently extended its know-how to Polymer Electrolyte Membrane (PEM) fuel cells. Users include industrial sites, laboratories and medical structures. Applications include energy transitions such as hydrogen-powered transportation and industrial decarbonisation, through large hydrogen generators (1-5 MW) applied to green mobility via hydrogen refuelling stations, power-to-gas and synthetic methane systems. A major scale-up is planned in 2023, through the construction of a new large plant that will increase capacity from 8 to 60 MW a year.

We believe the company has gained a clear competitive advantage vs actual competitors and potential entrants, due to accumulated experience and in-depth knowledge resulting in proprietary, hard-to-replicate and efficient technologies. On-site generation will gain momentum as users require tailor-made and flexible solutions compared to the purchase of standard gas cylinders. In addition, on-site production is safer, cheaper and greener. The balance sheet is strong and the business has low capital intensity and is cash generative.

The company has a market capitalization of 75 million, and expected 2022 revenues of 13 million, set to grow at a rapid pace in the next few years at very healthy profit margins. We paid 12 per share at IPO. The stock ended the quarter at 11.6 euro.

The current sector composition of the Fund is the following:

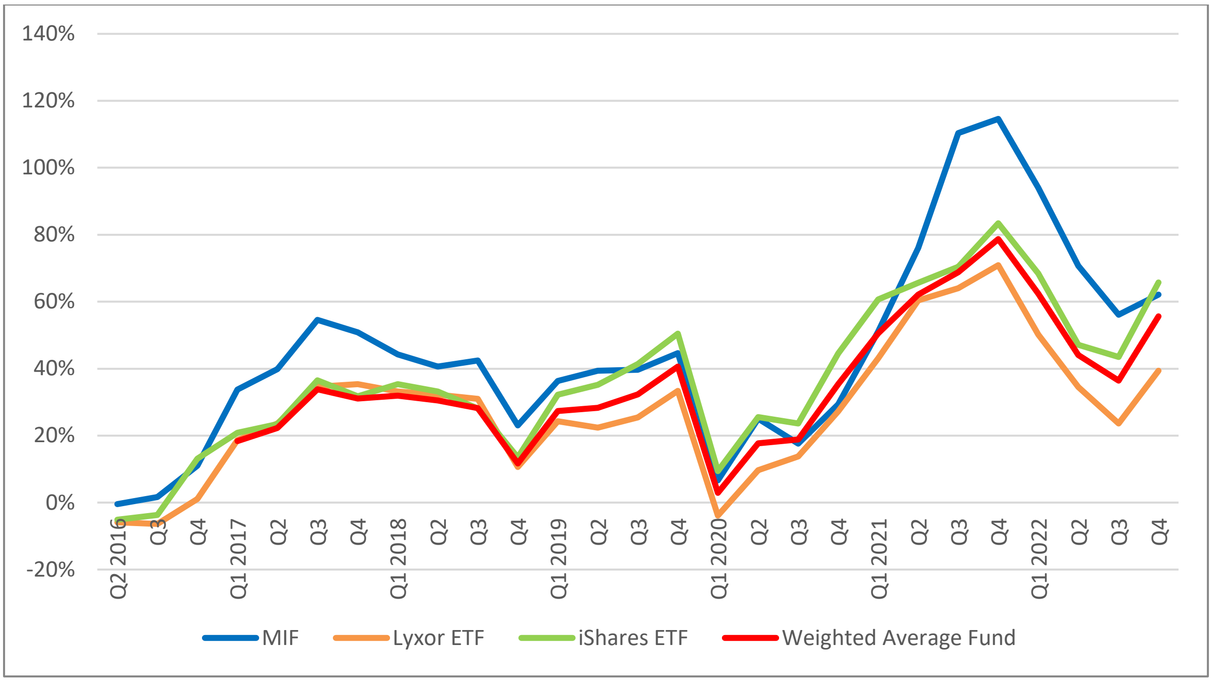
	Number of companies	% Weight
Producer Manufacturing	6	13.8%
Electronic Technology	3	5.6%
Process Industries	2	2.6%
Consumer Non-Durables	1	1.7%
Consumer Durables	3	6.3%
Industrial Services	1	6.5%
Commercial Services	6	12.8%
Consumer Services	3	6.2%
Technology Services	8	21.2%
Distribution Services	1	2.9%
Health Technology	2	4.8%
Retail Trade	1	3.1%
Communications	1	2.3%
Finance	3	4.3%
Utilities	2	4.1%
Total	43	98.2%
Warrants + cash		1.8%

We have been there

Our underperformance in the second half of the year is particularly disappointing, as it is in contrast with the outstanding first-half financial results reported by our companies, as detailed in our Q3 letter. We were also right in anticipating a positive fourth quarter, against the gloomy predictions of most market commentators. Indeed, as we have seen, the rebound was robust and widespread across most equity markets, especially in Europe, encompassing large caps as well as mid and small caps. Except in Italy, however, where small cap performance was distinctly more subdued, and ours was even a bit lower.

As a result of such underperformance, our return since inception, while remaining firmly above the most comparable Lyxor ETF as well as the weighted average return of Italian Equities Funds, has now fallen slightly below the iShares MIB ETF.

Displeased as we are about it, however, we are not overly concerned. As our regular readers will remember, we have been there before. The graph below reports our return since inception against the returns of the two ETF and the weighted average return of the extant Italian Equities funds at the end of each quarter (Note: the number of funds varies through time as some are closed and new ones are created):



The graph shows that the MIF has constantly achieved its primary goal: to be a better choice than its most comparable ETF – not quarter by quarter, or even year by year, but over the long term. Our return since inception has *always* been above the equivalent return of the Lyxor ETF, *after* fees and administration costs. In addition, such extra return has been attained with a significantly lower volatility, as shown in the first-page graph of our quarterly letters.

The MIF has also achieved its second goal: to be a better choice than the average mutual fund invested in Italian equities. Except for two quarters in the middle of the pandemic mayhem of 2020, our long-term return has constantly been above the equivalent return of the weighted average Italian Equities fund, again after fees and all administration costs. And again, such extra return has been obtained with a much lower volatility.

As most Italian Equities funds are invested around the main market MIB benchmark index, their weighted average return is highly correlated with the return of the iShares MIB ETF, albeit typically a bit lower because of higher fees. The graph shows that the MIF has largely achieved its third goal: to be a better choice than the MIB ETF. As we said, however, there has been a period, between 2019 and 2020, in which our long-term return temporarily fell behind. As explained in our Q3 2019 letter, this was the result of a yawning performance gap between large cap and small cap stocks that had started in 2018 and continued in 2019, at the same time when, in a contrarian move, we were increasing our exposure to *smaller* cap AIM stocks, which had been vastly underperforming both. It was an uncomfortable time, but we stuck to our guns and by Q3 2021 came back with a vengeance.

Likewise, we are uncomfortable about our 2022 result. The year turned out to be very different from what we were expecting at the start. Clearly, we were not looking for a repeat of the extraordinary result of 2021. But we envisaged another positive year, in absolute and relative terms. Hence, in defiance of the first negative quarter, we pledged: We shall not revert to the mean. As the second negative quarter unfolded, we explained why, in our opinion, the blanket derating of stocks around the world, and in particular in our portfolio, made no sense. Until then, however, our negative return was in line with our comparisons. But in the third negative quarter small cap stocks did significantly worse than large caps throughout Europe, including Italy and most of our stocks, despite their excellent first-half reported results. Again, we pointed out the senselessness of such indiscriminate declines and explained why the best course of action in such circumstances is to sit tight and do nothing. We also noted the rarity of three consecutive negative quarters and, against the prevailing bearish market sentiment, ventured to predict a positive fourth quarter. We were proven right: both large and small cap stocks had a strong rebound, especially in Europe. But alas not in Italy, where, as we said, small caps – and our Fund with them – registered a positive but weaker performance.

Our second-half underperformance versus the MIB index was large enough to drive our long-term return slightly below the iShares MIB ETF, as it happened in Q3 2019. Is this a one-off episode or the beginning of a new period of small cap underperformance? We do not know. All we know is that our stocks were attractively valued at the beginning of 2022 and became even more attractive by the end of the year. Nothing happened to our companies that made us lower our fundamental valuations. On the contrary, their first-half results strengthened our investment case, and the price drops widened their valuation gaps. We do not know when the gap will close, but we know it will. The premium takeovers of BE in Q1 (+31%), Piteco in Q2 (+24%) and Finlogic in Q4 (+69%) are a clear indication of the pent-up value compressed in our stocks.

What now?

We ended the Q3 letter with a call to put more money at work, and we are glad that some investors listened. After a muted Q4, we reinforce the message. Expecting 2023 to be a better year than 2022 does not require a huge flight of imagination. We certainly believe it will be. Inflationary pressures took longer to be repressed than originally thought, but they do seem to be reducing in most countries – as we predicted in the Q2 letter – while interest rates are back to more normal levels. Economic growth may be slower, and some countries may flirt with a mild recession, but the likelihood of the dire stagflationary scenarios bandied about earlier on appears more remote. The Ukrainian war is ongoing after almost a year, and it still comes with its bag of worries. But the probability of a positive resolution, possibly through a regime change in Russia, is increasing. Other negative surprises may surface, including a recrudescence of new Covid variants. But, on the whole, it seems quite safe to say that 2023 will at least be a more stable year than 2022, and therefore more conducive to a better market environment, where investors who so far have preferred to remain on the side lines may take a more constructive attitude. In this environment our stocks will have a much better chance to express their appreciation potential.

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